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TAGS: ECON EFIN EUN
SUBJECT: Economic Forecast for Germany: Slow Growth and High Government Deficits Continue; Deflation Outside Risk; Building Confidence is Key

T-IA-F-03-37

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¶1. (SBU) Summary: Our forecast for Germany for this year and next is for continued slow growth with a modest pick up in 2004 driven by net exports. While 1.3% real growth in 2004 might be deemed a "recovery" after 0.1% growth in 2003 it is mostly closing a part of the output gap that has opened during three years of stagnation. Unemployment will remain in the 10.7% range and the government deficit will remain above 3% of GDP. This forecast incorporates possible effects of structural reforms announced in the agenda 2010 package (reftel), but these are likely to cause a drag on growth in their first year of implementation, with positive effects following in 2005 and later. End Summary

¶2. (SBU) Risks to this forecast are principally on the downside - that is the balance of risks suggest that the actual situation is more likely to worsen than improve. The absence of robust bank lending, weaker external demand, faster appreciation of the euro against the USD are some of the risks. Deflation is another, which we give only an outside chance of materializing next year.

¶3. (SBU) This forecast incorporates budget data from the Government's recently released 2004 budget, including bringing income tax cuts a year forward from January 2005 to January 2004. We have not yet estimated the possible effects on growth, although other estimates range from 0.3 to 0.6 percentage points of higher growth. Stimulus from income tax cuts could help offset some of the drag from structural reforms but carry other risks, e.g. higher deficits and debt service.

¶4. (SBU) Taking a broader view, investment will be a key to turning over Germany's growth engine. Declining investment has been a contributing factor to Germany's lackluster growth performance in the 1990's. Investment growth could be supported by relatively lower price and wage increases in Germanythan in its euro area partners and lower non-wage labor costs promised by structural reforms. Combined with income tax reductions, the announcement effect of such a comprehensive program on investors as well as consumers could be positive. This, then, would be the upside risks to the forecast.

Growth Prospects for 2003 and 2004: Slow Growth, Modest Recovery

¶5. (SBU) Seasonally adjusted real GDP is likely to grow slower than previously forecast: 0.1% in 2003, down from 0.7% and 1.3% in 2004 down from 1.8%. The first quarter's unexpected 0.2% decline compared to the fourth quarter last year has made even modest growth improbable for 2003.

¶6. (SBU) After years of flat growth a modest pick up in net exports in 2004 should spark growth of 1.3%, hardly a recovery as the economy has been stagnating and the output gap between actual performance and potential has widen. 2004 growth on a non-seasonally adjusted basis should improve to 1.8% due to four more working days in the calendar year.

Indicators and Sentiment Show No Sign of Recovery

¶7. (SBU) Business climate indicators do not signal any significant upswing. The ZEW indicator has flattened after rising for six months and is still will below its historical average. The ifo index rise in May, the first up tick since January, was weak, driven by expectations. But the assessment of current economic conditions remains poor. The economic sentiment indicator (ESI) for Germany from the EU Business and Consumer Survey shows stagnation at a very low level. Expectations concerning production, unemployment and the general economic situation over next 12 months have deteriorated, underpinning our forecast for continued stagnation in 2003.

Is there evidence that something will trigger a change in current trends? At the moment we do not see any.

¶8. (SBU) The increase in private consumption in the first quarter was unique and will not continue in the next three quarters (see below). One factor driving weak private consumption is a lack of confidence in a better outlook. New paper reports suggest that consumers are wary and anxious about high unemployment, climbing social taxes, financial difficulties of the Government and states and that the operational effectiveness of economic politics has declined.

¶9. (SBU) Recapturing the population's trust will not be easy. The controversy over economic reforms that began last September shows no sign of abating. Clear outcomes that could contribute to more confidence , as well as a conviction that a comprehensive economic program is being put into place, could help restore consumers' trust and interest.

¶10. (SBU) On the business side the sentiment is not any better. Entrepreneurs have been coping with high non-wage labour costs and structural restraints. Agenda 2010 reforms should help somewhat, provided the promised reforms are put into place. Heated debates over the reforms, and rumors of possible tax hikes to ease the government budget deficit, put into doubt what the government will actually end up doing, contributing to uncertainty and delays in investment decisions. Enterprises place their hope, once again, on foreign demand. Such demand will be only slightly affected by the euro appreciation as most German exports go to the euro area; imports should pick up, leaving a small net trade surplus to drive recovery in 2003 and a larger one in 2004.

First Quarter of 2003: False Start - Domestic Demand Not Sustainable

¶11. (SBU) Analysts note that despite the first quarter decline, the composition of demand was encouraging. Domestic demand grew while net exports declined, a potential sign that Germany could begin to grow its own way of economic stagnation rather than relying on a revival of external demand. We are not so optimistic.

¶12. (SBU) First quarter dynamics were attributable to one-off factors that will reverse in the course of the year. The savings rate was drawn down from 10.6% to 10.4% and net disposable incomes were higher due to a raise in entrepreneurial and interest income. Net income actually shrank by 0.4% compared to the previous quarter due to January's increases in payroll taxes (higher pension contributions (from 19.1% to 19.5%) and health insurance (from 14.1% to 14.4%) and higher taxes on petroleum, electricity, (i.e. the next step of the "Eco-tax" reform) and tobacco.

Other elements of domestic demand provide little comfort.

¶13. (SBU) Investment declined significantly by 1.7% in the first quarter due to a tremendous fall in construction investment. Taking into account capacity utilization, production and order entries, investment is unlikely to advance in the second quarter. Manufacturing capacity utilization is still under its long-term average, although the trend is up.

¶14. (SBU) Construction decreased in the first quarter by 3.3% due in part to the extremely cold weather. Even though the sector continues to work off its overcapacity, a gleam of hope in the first quarter was an increase in building permits. This rise may be attributed to the heated political discussion about cutting housing subsidies, provoking an unusual amount of applications for permits. Those with building permits would be entitled to the subsidy. Low interest

rates provide an incentive for immediate construction even though the building permit is valid for five years. Thus, construction in the housing sector should rise in the second and third quarters. Nonetheless, continued reduction in overall capacity will still result in a drag on GDP growth.

Government consumption, constrained by rising budget deficits, will remain modest.

The Story is Still External Led Growth

¶15. (SBU) The base scenario of the forecast remains for net exports to drive a gradual recovery in 2004: the rest of Euro area - taking 54.7% of German exports -- will grow faster than Germany. Thus, German exports are insulated to a significant extent from much of the effects of the euro's appreciation. In nominal terms, the euro is up 16.5% against the USD during the first half of 2003. A revival of foreign demand in 2004 both inside and outside the euro area should help override some of the price effects of more dear euro outside the euro area as German exports compete in high-end, quality and custom markets and between related firms where product substitution is difficult.

Fiscal Deficit: Over Maastricht Threshold

¶16. (SBU) The Government deficit will climb to 3.9% of GDP in 2003. Revenue is likely to decline as suggested by the results of the May tax estimate and our new GDP forecast. The result: a fiscal deficit of euro 41 billion. For 2004 the deficit will continue to be driven by revenue losses and draws by social insurance programs. The planned 2004 budget contains euro 15.9 billion in measures to reduce the deficit to around euro 26 billion. However, bringing forward the income tax cut would add another euro 7 billion to the Federal deficit and the same amount to the state deficits and around euro 2.5 billion deficit at the local levels. Thus, the overall government deficit will stay around 3.8% of GDP. Germany would neither meet its political commitment to reduce the nominal deficit below 3% in 2003 nor in 2004, the year in which Germany's excessive deficit is to be corrected under the rules of the EU Stability and Growth Pact.

CPI: Practically Price Stability

¶17. (SBU) Consumer price increases will remain subdued, even declining on a quarterly basis for some of the year due to the euro appreciation and lower oil prices, but rising overall at an annual average rate of 0.8% in 2003 and 0.9% in 2004 as demand begins to rise.

¶18. (SBU) Consumer prices rose in the first quarter 2003 by 0.7% over the previous quarter and by 1.1% compared to a year ago. In April and in May prices declined slightly on a monthly basis due to strong price declines in heating oil and gas (oil prices decreased immediately after the end of the Iraq war; the price decline was reinforced by Euro appreciation). These effects will continue throughout the year (basis effects), partially offset by rises in services prices.

Unemployment: No Cause for Joy

¶19. (SBU) The number of unemployed will increase by 9.8% in 2003 and decline by 1.6% in 2004 as economic growth picks up. The unemployment rate will remain around 10.7%.

Forecast Risks: On the Downside

¶20. (SBU) Risks remain as in the previous forecast, principally on the down side: lack of robust bank lending, weaker external demand, faster and higher appreciation of the euro/USD exchange rate.

¶21. (SBU) The lack of clear, fully agreed government fiscal and reform policies or actions with attendant political uncertainties weighs on consumer confidence - a factor that could continue into 2004. Deflation is not a feature in our forecast but is an outside risk toward the latter part of the forecast horizon, particularly if the anticipated upswing does not take hold.

A Broader View: Growth, Deflation and Fiscal Expansion

¶22. (SBU) This forecast has been composed in a period of fluidity: the government has announced a major structural reform initiative, subsidy cuts, and significant tax reductions by bringing forward to 2004 income tax cuts scheduled for 2005. This section takes a step back and seeks to discern a line of logic in

these measures that could give a basis for a more optimistic scenario than we have assumed. One way to look at what is going on is that relatively low inflation and structural reforms with tax cuts could help counter act the weak investment performance that has plagued Germany for nearly a decade. Both these mechanisms, structural reforms and relative price adjustments, are the "tools" now available to Germany in the monetary union to adapt to "shocks" it has suffered during reunification.

Why Weak Growth?

¶23. (SBU) The European Commisson's 2002 "Review of Germany's Growth Performance" points to several factors that account for Germany's prolonged low growth and vulnerabilities to external developments. Low growth stems from weak domestic demand: weak consumption and investment, including in the construction sector.

¶24. (SBU) Large financial transfers to the new states, around 4% of GDP annually, initially financed by larger deficits, now are financed by higher taxes diverting funds from social funds. These funds, in turn, have had to increase their contribution rates. Higher taxes and social charges crowd out private investment as expected profits are reduced and adversely effect employment, in the Commission's assessment. Low construction investment is the product of working off excess capacity in both the new States and the West from the heady early 1990 days of reunification and high immigration.

¶25. (SBU) The recently released Bank for International Settlements' Annual Report also highlights the decline in investment as "the strongest sign (if not cause) of the underperformance of the German economy." The BIS believes that while partially cyclical, the low propensity to invest is due to fundamental or structural factors such as low rates of return, low corporate profits, and product and labor market rigidities.

¶26. (SBU) A study by Goldman Sachs suggests that the massive cost shock from higher wages in the new states and the West associated with reunification encouraged firms to substitute capital for labor. Lower profitability reduced the incentive to invest. The BIS notes that since the early 1990's net investment in Germany has fallen sharply. Goldman Sachs points out that compared to 1991 the real level of investment is only 6.5% higher in Germany while in the rest of the euro area it is 23% higher. In 2001 and 2002 investment continued to decline, as we forecast it will this year.

¶27. (SBU) Lower inflation in Germany relative to that in its main European trading partners suggests that its external competitiveness will increase, supporting exports and growth. This relative price adjustment is one way regions experiencing relatively slower economic activity in a monetary union can adjust. Thus, relatively lower inflation could benefit Germany. However, it also raises the risk of deflation.

The "D" Word

¶28. (SBU) While we have not found any economists to declare that deflation is occurring in Germany, most all will admit that there are risks, even the usually reserved Bundesbank. This is playing it safe. There is a general suspicion that, as the BIS explains, "a seemingly benign low-inflation environment can turn into one with disruptive deflation." Deflation can be there before you know it. Moreover, the costs are high, more disruptive than inflation. Many of these adverse effects bear directly on investment.

¶29. (SBU) One definition of deflation is a decline in the general price level on a sustained basis that reduces demand. This definition would rule out the more benevolent form of price decreases due to supply shocks, like new sources of supply or higher productivity, that can drive down prices but contribute to faster economic growth. Deflation that is pernicious constricts investment: firms hold off investment as the real cost of credits increase and profits are squeezed because consumers hold off purchases and nominal wages are "sticky," keeping production costs higher than otherwise.

¶30. (SBU) It takes more than low inflation to move to deflation, but Germany has a number of those other necessary attributes. A growing output gap, weak credit growth, and soft equity prices are fertile ground in Germany for deflation, according to a recent IMF staff assessment. Nonetheless, the IMF paper

concluded that "mild deflation is likely to take hold" but that "the risks of pernicious deflation are low."

¶31. (SBU) Deutsche Bank research developed its own "scoreboard" of 10 indicators that gave Germany a 0.5 compared to 0.7 in Japan where deflation has taken hold and 0.4 in the US. While they see some negative inflation during the year, they give a 20-30% probability that deflation could last for more than a year, and a lower probability to dangerous deflation taking hold. This would require continued stagnation in economic growth, continued low credit growth, a substantial further appreciation of the euro to around 1.40/usd, inflation expectations would have to fall (no signs yet that consumers expect lower prices - just stable prices) and inflation in the euro area would have to fall below 1%.

¶32. (SBU) This last point is worth noting. The European Central Bank asserts that price developments in Germany cannot be considered in isolation from price developments in the rest of the EMU. The ECB considers average euro area inflation and pitches its monetary policy for price stability, i.e. price increases of 2% or less, but still close to 2% to protect against possible deflation (this latter point is an important clarification recently issued by the ECB). With Euro area inflation still running around 2% and Germany's inflation at 0.7%, that means other countries are running substantially higher inflation than Germany. As noted above, this should improve Germany's competitive position within the euro area.

¶33. (SBU) Deutsche Bank research provides an illustrative example. The posit that if euro area inflation were to remain around 2% (the ECB's definition of price stability), Germany, with a weight of 30% of the monetary union, would have to have negative 1% inflation and the rest of the Euro area would average 3.5% inflation - a gap of 4.5 percentage points. At such a spread there should be opportunities for pricing arbitrage for tradable goods, raising demand in Germany.

Role of Fiscal Policy and Reforms

¶34. (SBU) Another way to counter the price shocks adversely affecting investment could be reductions in taxes and non-wage labor costs that have restrained demand for labor and investment. The Finance Minister has politically linked advancing the income tax reductions to adoption of structural reforms and a trimmed 2004 deficit that is less than planned investment. In addition, some short-term stimulus to economic growth from the tax reductions, estimated to range from 0.3-0.6 percentage points, could help offset the drag on growth from the early stages of structural reforms.

¶35. (SBU) At a time when there is a risk of deflation and confidence is fragile, the Government appears to be seeking to take economic matters into its own hands. This, Finance Ministry officials agree, should help instill confidence in consumers and investors.

¶36. (SBU) The BIS suggests in its annual report that a counter cyclical fiscal policy combined with an expansionary monetary policy and other reforms would provide a "more potent cocktail" of stimulus to deter the threat of deflation. However, in Germany a recent survey (Infratest) suggests, that still 81% of respondents were less satisfied or not at all satisfied with the government's economic policies. 81% of the respondents opposed taking on new debt to pay for bringing forward the income tax cuts. This suggests that rather than spending the savings from tax reductions, many might save them in anticipation of higher taxes in the future to help reduce the debt.

Forecast- Germany
(Percent Increases - Unless Noted Otherwise)

	2002 ACTUAL	2003 FORECAST	2004 FORECAST
GDP :	0.2	0.1	1.8
CONSUMPTION:	-0.6	0.5	0.9
GOV. CONSUMPTION:	1.5	0.6	1.2
INVESTMENT:	-6.7	-2.0	1.0

- MACH. & EQUIP.:	-9.4	-0.3	2.7
- CONSTRUCTION:	-5.9	-3.7	-0.9
- OTHER INVEST.:	2.5	2.2	6.3
NET EXPORTS:	51.1	-6.5	8.6
- EXPORTS:	2.6	3.0	5.9
- IMPORTS:	-2.1	4.5	5.6
NOM. GDP: (Euro Bill)	2108.2	2127.2	2174.0
CURRT. ACCT. (Euro Bill)	48.9	44	59
PRICES:	1.3	0.8	0.9
EMPLOYMENT (Thousands)	38,689	38,156	38,300
UNEMPLOYMENT (nat. definition) (Thousands)	4,071	4,470	4,400
UNEMPLOYMENT RATE (Pct; nat. def.)	9.8	10.7	10.6
TOTAL FISCAL BALANCE: (Pct. GDP)	-3.8	-3.9	-3.8

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